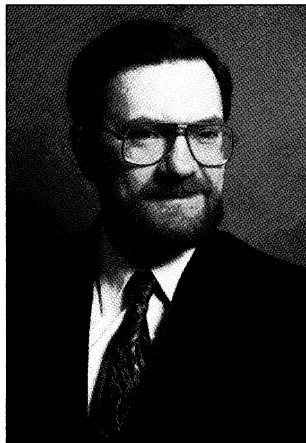


While competition is a dynamic force of change, it may also be a force of concentration. Winners will expand and are likely to use whatever means at their disposal to consolidate their turfs. Trade liberalisation without safeguards for fair competition could dangerously cause increasing concentration in some industries and less competition in the end. Should this be the case, the world trade could eventually stagnate for these industries, running contrary to the original intention of GATT negotiations. Consequently, the maintenance of competition is not only a supplement to the new world trade order, it should be part of the core, as it is key to the healthy survival of that new order.<sup>92</sup>

## Competition first: engendering a regulatory framework in which developing economies can consider privatisation

The following article by Commission Deputy Chairman Allan Asher discusses issues of privatisation in relation to developing countries, in the light of Australia's experience in the reform of infrastructure services. It is based on a paper presented to the International Conference on Competition Policy and Economic Adjustment arranged by the World Bank, OECD and the Global Forum on Competition Policy — International Bar Association in Bangkok, Thailand on 27–28 May 1999.<sup>93</sup>



### Introduction

The British experience suggests the need for better integration of any privatization proposals with promotion of competition and preventing abuse of monopoly power in the industry, and for getting the regulatory framework right.<sup>94</sup>

Developing economies have legitimate expectations of strengthening sometimes-fragile infrastructure and bringing short supply of essential services into some sort of balance with demand. They also have wider social goals of promoting interaction and sharing opportunities between rural areas and cities, developing levels of literacy and skills, equitably distributing increases in national wealth, and harnessing technologies appropriate to the financial resources of the economy and the needs of its people and of the environment.

Privatisation is an instrument for attracting investment and improving the output and efficiency of economic sectors. However, advocates of reform initiatives must address the legitimate social goals of developing economies. Australia's deregulation and privatisation experience, in particular its policy emphasis on a competitive framework, has useful lessons.

### The Australian context

Australia's implementation of micro-economic reform has focused on the network infrastructure industries including energy, telecommunications, airports, railways and water supply. Notable features include:

- incentive-based regulation of revenues or prices of natural monopolies;
- third-party access to infrastructure services to create opportunities for upstream and downstream competition;
- corporatisation or privatisation of government utilities so that resource utilisation and service provision mimics outcomes in a competitive market;
- winding up of territorial franchises; and
- jurisdictional review of legislation that restricts competition, subjecting it to a net public benefit test.

92 Yun-Peng Chu, 'Towards the Establishment of an Order of Competition for the International Economy', *International Harmonisation of Competition Laws*, ed. Chia-Jui Cheng et al, Dordrecht: Martinus Nijhoff Publishers, 1995, 399 at 453.

93 This article was prepared with the assistance of Peter Le Mesurier, Regulatory Affairs Division, ACCC.

94 Australian Consumers' Council, *Privatization of utilities: how are consumers affected?* Australian Government Publishing Service, Canberra, April 1995, p. 28.

Firms in network industries have market power because it is often inefficient for more than one or very few firms to establish facilities, and users lack effective bargaining strength. Vertical integration reinforces such market power and can be a motive for anti-competitive conduct. There is a strong case for regulating service providers at bottleneck points in the supply chain.

Previously, regulation focused solely on downstream prices. In the absence of market pricing mechanisms and interstate connections this has caused misallocation of investment funds, such as selective underproduction and over-investment. Downstream price control cannot correct these imbalances whereas incentive regulation can reward rational investment decisions and punish unsustainable decisions.

Australia's competition policy reform goals are intended to serve wider social issues, including:

- ecologically sustainable development;
- social welfare and equity, including community service obligations;
- economic and regional development, including employment and investment growth;
- consumer interests; and
- the competitiveness of Australian businesses.

Of all the industries undergoing reform, the energy sector has the potential to contribute most to improved gross domestic product.

### The context of developing economies

In Asia the energy industries have similar growth potential to those in Australia but demand and supply are out of balance. The decision whether to privatise really forms part of a broader context of policy objectives including investment incentives, security of supply and balance of payments consequences.

For example, India suffers frequent power blackouts in every city and village. Specific causes identified in a study by Dr B.V. Shenoy include:

- fixed-price long-term contracts inhibiting gas production, with gas being sold below the cost of alternative energy sources; and

- subsidisation of kerosene prices, which has resulted in diversion of product from poor users to blending with petrol and diesel for transport and captive generation. This has led to India 'using the largest quantity of diesel in power generation in the world', with adverse consequences for refinery yield balancing and levels of air pollution.<sup>95</sup>

### Impacts of privatisation and other reform options

To my knowledge there has not been a study in Australia to date that successfully distinguishes between the relative impacts of privatisation and other reform paths. However, whether the utilities were in government or private hands, without the regulatory review of utility revenues, prices would be considerably higher with no appreciably better service.

Australian academics Dr Stephen King and Professor Rod Maddock have surveyed overseas literature and concluded:

Probably the most widely shared view is that ... 'market structure is of great importance' and more generally it is the degree of competition to which firms are exposed which best explains their performance. This is one of the few decisive points to come out of this literature: competition seems to work.<sup>96</sup>

In the Australian telecommunications industry, until 1991 the main carrier, Telstra, essentially had a monopoly. In 1991 a second fixed-network competitor, Optus Communications, and two additional mobile services competitors, Optus and Vodafone, were licensed. In 1997 the market was opened to others. Since then, many new competitors have entered the market, particularly in high-margin areas such as business services. Until 1997 Telstra was wholly a government enterprise but in November 1997 one-third of the company's ownership was privatised, and now a further sixth is to be sold.

Fixed telephone service call charges for the price-capped services of Telstra have been trending down over the decade. This has

<sup>95</sup> Shenoy, B., *India's energy crisis*, Mysore Grahakara Parishat, January 1996.

<sup>96</sup> King, S. and Maddock, R., *Unlocking the infrastructure: the reform of public utilities in Australia*, Allen & Unwin, 1996, p. 6.

coincided with demand-management pricing, incentive-based regulation, rapid technological advances, new competitors and progressive contestability of customers made possible by facilities-based and access-based competition. Standard prices for existing mobile services have not significantly changed, reflecting a focus by the three carriers on attracting new customers. To foster price competition, new mobile service providers will be licensed.

In the energy sector, in the past decade electricity assets in only one State, Victoria, have been privatised. Gas retailing has traditionally been a government business activity in some States and a private sector activity in others. Victorian gas assets have been privatised only over the last few months, and South Australian electricity assets are to follow. What the Australian statistics show is that:

- average real prices for electricity have been trending down in most States, with commercial customers generally enjoying the more significant reductions;
- most of the price reductions and improvements in reliability in Victorian electricity occurred before privatisation; and
- average real prices for gas nationally have been relatively constant for domestic, commercial and industrial customers.

Utilities that charge average to above-average electricity prices to franchise customers charge among the lowest prices to contestable customers. Australian energy users have been made progressively contestable since late 1994. All are expected to be contestable in the first few years of the new decade.

Some publications of the World Bank suggest caution toward privatisation in developing economies, emphasising the need first for an appropriate regulatory environment, an approach that is entirely justified. In my view it is a mistake to make privatisation an end-point. It is only one step in a reform process, and there may be viable complements and alternatives such as alliances, joint ventures, shared facilities and yardstick comparisons. Ongoing competition and regulation of market power are fundamental to realising benefits.

A proponent in India of privatisation (Dr Shenoy) has called for complementary

measures including nationally coordinated policies for purchasing resource commodities, competitive market practices and regulatory bodies with a consumer focus commensurate with those in technologically advanced countries.

### **Some watchwords for privatisation**

The goals of government in privatisations may be wider than micro-economic reform, for instance, redirection of government expenditure from one area of service delivery to another, repayment of public sector debt and reduction of government sector initiatives.

Although my comments are cautionary on privatisation in developing economies, that is not an endorsement of a 'do nothing' strategy if the performance of enterprises is below standard. A fundamental purpose of government is to foster improvement in national wealth and to enable the community to share in that wealth.

Experience suggests watchwords for managing potential privatisations.

- Prior operation of a regulatory framework incorporating incentive-based regulation is essential.
- Treat experts with caution, as they are apt to have a narrow focus.
- Apply relevant financial and social risk parameters when evaluating government enterprises and utilities.
- Design incentive structures for the privatisation process to address economic goals including transition to competitive markets, the economy's pattern of social organisation and production and wider community aspirations.
- Take an accountable, transparent approach which engenders confidence in regulation.
- Don't overlook the need for reforms in sectors in private ownership with which government enterprises interact. For instance, foster competition in supply upstream of a privatising transmission or retail sector.
- Prepare an income and employment transition path for members of the community affected by privatisation.

- Involve the community long-term in regulation by addressing the economy's particular social and economic organisation, institutions and levels of literacy and numeracy.
- Don't overstate the benefits of any proposed course of action.

### Regulatory principles and design

The actions of a regulator could cause uncertainty and risk for an investor. Uncertainty weakens incentives to initiate changes in operations, so that a higher rate of return is required for investment. Greater efficiency and other social goals may be forgone or come at a higher price.

To minimise regulatory risk, the Commission has adopted the following guiding principles developed for the Utility Regulators' Forum:

- communication/consultation with stakeholders;
- predictability, strengthened by public review processes;
- flexibility to adopt emerging regulatory tools and to recognise local market conditions; and
- effectiveness and efficiency in regulatory assessment.

Effective regulation would be incentive-based, setting parameters for revenue recovery that encourage efficiency and incorporate explicit mechanisms for sharing the benefits of efficiencies between utility owners and users.

### Incentive regulation

Incentive regulation aims to replicate the assumed beneficial effects of competitive markets — that they achieve optimal efficiency in production, pricing and economic welfare.

Incentive regulation is the use of rewards and penalties to induce the utility to achieve desired goals where the utility is afforded some discretion in achieving goals.<sup>97</sup>

<sup>97</sup> Lewis, T. and Garmon, C., 'Fundamentals of incentive regulation', *PURC/World Bank International Training Program on Utility Regulation and Strategy*, June 1997, quoted in S.V. Berg, 'Introduction to the fundamentals of incentive regulation', *ACCC/PURC Training Program*, 16 October 1997.

There is a large and expanding literature on incentive regulation. An effective regulatory framework would have the following features:

- public decision-making processes, with accessible, timely information at the level required to meet regulatory objectives;
- clear definition and commitment, with review of revenue or price caps and service standards at defined intervals or on the occurrence of defined 'triggers';
- a revenue/price cap based on forecasts of the cost of service including return on capital (asset base) over the regulatory review period;
- risk-adjusted rate of return on the asset base commensurate with prevailing conditions in the market for funds; allowable return determined on a post-tax nominal basis, with estimated tax for the regulatory period explicitly part of the cost of service;
- annual 'CPI-X' adjustment of the cap and inflation adjustment of the asset base, with efficiency gains and revenue-smoothing reflected in 'X';
- periodic revaluation of assets where justified according to a consistent theoretical basis;
- depreciation recovery over the economic life of the asset, providing an efficient time profile of revenues and tariffs;
- sharing of efficiency gains by a formula such as a 'glide path';
- explicit published service standards and implementation support mechanisms such as consumer charters; and
- independent dispute resolution accessible by users.<sup>98</sup>

### Other tools for achieving competitive outcomes

To make contestability of markets viable, in Australia there are legal sanctions against anti-competitive conduct (price agreements, market sharing and anti-competitive mergers). National consumer protection legislation and powers

<sup>98</sup> These features are applied in the ACCC's *Draft statement of principles for the regulation of (electricity) transmission revenues* at <http://www.accc.gov.au/electric/fs-elec.htm>.

giving the regulator standing as an advocate of 'best practice' regulatory measures give complementary protection to the individual against misuse of market power.

In Australia, published service standards (for example, benchmark customer contracts) and monitoring reports have been important in exposing to scrutiny the levels of performance of utilities in supplying their services.

Nevertheless, consumer advocacy bodies have identified shortcomings, of greatest concern being a body of cases of harsh treatment of consumers having payment difficulties and deficiencies in making them aware of 'safety net' assistance.

Downside effects of corporatisations and privatisations are being acknowledged in the advanced economies. It would be a tragedy if these community welfare problems were not similarly addressed in the developing economies. A market in which business is unfettered by obligations to consumers is fundamentally unhealthy.

### **Particular needs of a developing economy**

In designing regulatory principles and processes it is important to promote consistent principles and practices across jurisdictions, both within countries and between countries in the same economic zone. From the Australian experience a checklist of measures that I believe are necessary in a developing economy contemplating privatisation or other reform measures would be as follows.

#### *Legislative*

- National competition and consumer protection law with complementary law and codes for incentive regulation of essential service providers.
- An independent regulatory agency.
- Appeal bodies and bodies for the protection of integrity in decision-making.
- Transparent processes where the regulator is asked to take account of government views.
- Full public participation in regulatory review processes and in developing community service obligations.

- Government commitment to ensuring that community service obligations are funded.
- An open approach to considering the full range of reform options.
- Planning and measures to deal with unemployment and environmental issues, and to address contractual and cultural factors that would otherwise favour incumbents.

#### *Regulatory*

- Resourcing of a national regulatory body capable of taking an integrated approach to competition, consumer protection and incentive regulation.
- Capacity-building (recruitment, information services and training) to prepare for regulatory reforms.
- Regional and international regulatory forums to share principles, approaches and experiences and to develop regulatory cooperation and links with representative business and consumer organisations.
- Compliance education for business, and community education and outreach programs to consumers, farmer bodies and small business in urban and regional areas.
- Service standards, and codes to underwrite them, access by consumers to avenues for redress and dispute resolution, and effective communication of information to consumers.
- Coordination with other government agencies and with corporate and community leaders to ensure that communication difficulties arising from illiteracy are surmounted.

#### *Business and rural*

- Internal compliance education programs in enterprises and utilities.
- Cooperation in outreach and regulatory implementation programs.
- Educational programs, including ethical issues, by professional bodies.

#### *Consumers*

- Vigorous, broadly representative and funded public forums and associations to debate reform implementation issues.

*International agencies*

- Independent oversight by the World Bank and others of structural and regulatory reforms, transitional measures and ongoing regulation.
- Refocusing from predisposition to privatisation to consideration of the available options to meet economic and social needs.
- Independent research expertise, through the International Energy Agency or others, to evaluate whether target benefits are being delivered.
- Aid from experienced partner countries in developing the capacity of regulators and advocacy bodies to be effective.
- Sponsorship of cross-border regional regulatory forums.

If there is a refocusing of effort to these measures, I am optimistic that reforms can proceed to the benefit of the people of developing economies.

## Extended warranties

*This article by Darren McMillan of the Commission's Brisbane office examines some possible trade practices issues associated with the offering of extended warranties on various goods in Australia. The article seeks to highlight some of the problem areas associated with extended warranties, as evidenced from the complaints the Commission regularly receives. In particular, it focuses on a recent investigation by the Brisbane office into extended warranties offered by Brashs Pty Ltd which raised some important consumer protection concerns.*



### What is an extended warranty?

An extended warranty may be defined as an agreement between a purchaser of a particular

good and another party under which that party assumes the cost of repair or replacement of that good resulting from mechanical defect or breakdown, wear and tear, deterioration and/or other reasons.

It is known as an extended warranty because it typically extends any express or 'voluntary' warranty offered by the manufacturer or supplier of that good. An extended warranty may or may not offer protection to the consumer above and beyond the implied warranty provisions of the Trade Practices Act. The implied warranty provisions, which are considered later in this article, apply regardless of any express or extended warranty offered by the manufacturer or supplier.

A party offering an extended warranty might be the manufacturer, the vendor of the goods (owner, dealer etc.) or a third party (stranger) to the sale. The extended warranty is normally offered at a cost to the purchaser, similar to a premium levied on a standard insurance contract.

In Australia, extended warranties are offered on a wide range of goods, but particularly on used motor vehicles, household electrical and white goods and computers. The following matter outlines one such extended warranty that was offered by Brashs Pty Ltd.

### Brashs Pty Ltd

The Commission's Brisbane office recently conducted an investigation into Brashs Pty Ltd's 'five year extended warranty', which it offered on its range of appliances including TVs, audio equipment and computers. Brashs offered the extended warranty to its customers for a fee of roughly 10 per cent of the good's purchase price, to extend the manufacturer's own warranty period to a maximum of five years. The extended warranty commenced upon the expiry of the manufacturer's warranty, covering the cost of parts and labour for mechanical and electrical defects that occurred in the product up to five years from the date of purchase. From late 1997 the extended warranty envelope represented that the contract was administered and underwritten by American Home Assurance Company Limited (AHAC).